The Institute for Energy Law
of
The Center for American and International Law
53rd Annual Institute on Oil And Gas Law

Remarks by
William L. Massey Commissioner
U.S. Federal Energy Regulatory Commission

"The Current and Future Gas Industry"

Houston, Texas
February 21, 2002

Good Morning. I am honored to address this distinguished gathering of lawyers, corporate officials, academics and policy makers.

I am a lawyer by training, and eagerly anticipated bringing my legal prowess to the FERC nine years ago. I quickly learned that, although thousands of lawyers make a good living practicing before FERC, we primarily are engaged in energy policy making rather than legal analysis. A degree in economics would actually be more helpful.

The federal laws that govern the natural gas and electricity industries haven't changed much in the past decade, yet there has been a sweeping policy revolution in the way in which natural gas and electricity are sold and transported. The federal courts have told us that a just and reasonable price can be set by cost of service regulation – we know how to do that, and regulators did it for years, for good or for ill. But now, we have come to believe that markets can allocate resources and set efficient prices better than regulators. And in validating market based policy choices made by the FERC in Order Nos. 636 and 888, the federal courts have declared that a market-based approach can also produce a just and reasonable outcome, but <u>only</u> if the market functions well enough to actually discipline the price.

And so now virtually all of the Commission's orders ask this foundational question either implicitly or explicitly: what policy choice will facilitate a well functioning market? This is the common thread in all of our decisionmaking.

When we certificate a new pipeline or LNG facility, we are motivated by a desire to ensure that the gas market has an adequate infrastructure. The California electricity crisis that began in the summer of 2000 made us painfully aware that an inadequate energy infrastructure can lead to soaring prices and unacceptable volatility. It also made us painfully aware of the limitations on our jurisdiction under the Federal Power Act and Natural Gas Act. We cannot site electric transmission lines, even if they are vital to a well functioning wholesale market. That is left to the states, as is the siting of electric generation. We cannot ensure that there is sufficient intrastate take away capacity at interstate delivery points. A well functioning market requires the necessary interstate and intrastate infrastructure. We encourage states in this area, yet there is little we can do if a state fails to act. This division of authority, while perhaps politically necessary, sometimes frustrates the decisionmaking necessary for well functioning wholesale markets.

When we told pipelines in Order No. 637 that they must allow shippers to segment capacity, we did so with the needs of a well functioning market in mind. I could give scores of other examples. Our policy promoting the formation of Regional Transmission Organizations is aimed at facilitating independent, large regional platforms on which vibrantly competitive electricity markets can flourish. My point is that the policy evolution at FERC is focused on ensuring good markets for gas and electricity, and that will be the focus in the future as well. The Commission remains committed to making a market-based approach work for energy consumers.

This may seem obvious, yet in the wake of the California energy crisis and the demise of Enron, some are suggesting that energy deregulation is a failure. They argue that the California crisis was strike one, and that the Enron bankruptcy was strike two.

The disaster in California taught us that the elements of a well functioning market must be in place for competition to discipline prices. Those elements are adequate supply, sufficient transmission capability, forward contracting and appropriate hedging, good congestive management protocols, and a limited reliance on the spot market for meeting a purchaser's needs. The California crisis literally shouted to us that good markets that produce reasonable prices must be well structured. Federal and state policy makers must cooperate rather than blame each other. It does not mean, however, that the movement to competitive markets is a failure. It means absolutely that we must redouble our efforts to ensure that the market is structured to produce just and reasonable prices.

Enron's demise is shocking and a disaster for many reasons, among them thousands of workers lost their jobs and retirement nest eggs, and investors lost their shirts. There are certainly important policy lessons, but based upon what I've seen so far, these lessons seem to arise in other policy arenas such as retirement, accounting and securities regulation. All of these issues will be thoroughly investigated by Congress and federal agencies, as well they should be.

Several members of Congress and some market participants are claiming that Enron may have used Enron Online or its broader market position to distort electric and gas markets in the Western United States. In response, the Commission has recently opened a broad investigation into whether any entity manipulated Western markets. In the course of this investigation, we will look at both physical and financial markets, both short and long term.

If Enron's demise offers lessons for our evolving energy policy, we most certainly must heed those lessons. If there was market manipulation by any entity, we must uncover it as soon as possible and impose appropriate penalties. Based upon what I've seen so far, however, nothing persuades me that the Commission's general policy direction is unsound. I have seen no evidence that Enron's demise was a result of a flawed energy policy. Moreover, the market seemed to adjust well. Our largest energy trader failed, but other market participants quickly stepped in. It may be that some long term contracts still must be unraveled, but the energy market itself seemed to have the depth and flexibility to adjust well.

Thus, the Commission remains undeterred. Although we have had bumps in the road, we continue to believe that a market based approach holds promise for consumers. Unless Congress tells us to change policy directions, and I do not see that happening, we will continue to promote robust markets for gas and electricity. We will insist that consumers benefit.

If I may return now to the issue of our infrastructure, the tragic events of September 11 have brought a more immediate focus on the need to ensure that our critical energy infrastructure facilities – gas, electric, oil and hydroelectric – are protected from terrorist threats.

On September 14, the Commission issued a policy statement indicating that it would give "its highest priority" to processing any filing made for recovery of extraordinary expenditures to safeguard jurisdictional facilities.

The Commission took another step to safeguard critical energy infrastructure on October 11 in announcing that we were limiting access to certain public documents containing specific information on energy facilities. Generally, this information consists of maps and other geographic data that would help locate energy facilities. This information has been removed from the Commission' s website and the public reference room. However, it remains available under the Freedom of Information Act. On January 14, we initiated an inquiry into how the Commission should provide public access to critical energy infrastructure information while ensuring that this information cannot be misused by potential terrorists. The deadline for public comment on this notice expires shortly, and I am confident that we will receive many constructive suggestions.

On October 12, the Commission issued an order approving the reactivation of the Cove Point LNG facility. Our action, coming just one month after the terrorist attacks, stirred up a hornet's nest. We were besieged by criticism from Capitol Hill and local Maryland officials. The environmental analysis of the proposed plant reactivation prepared prior to September 11 specifically considered the impact of a terrorist act, and dismissed it as being remote. However, in view of the events of September 11, a number of parties sought rehearing of the certificate order. These petitioners expressed concern about the proximity of Cove Point to the Calvert Cliffs nuclear generating facility located four miles away. We took these concerns very seriously.

In the end, in response to these concerns, the Commission held a closed hearing on the safety implications of allowing LNG tankers to enter the Chesapeake Bay for deliveries at the facility. The Commission heard testimony from landowners, local officials, the FBI, Coast Guard, the NRC and experts in LNG safety. We ultimately determined that the facility could be operated safely, and does not pose a specific national security concern or a threat to the security of the Calvert Cliffs facility.

At this point, the future of the Cove Point facility is in the hands of the U.S. Coast Guard which, along with the Department of Transportation, bears the regulatory responsibility for approving the siting and safe operation of the dock and appurtenant facilities for offloading LNG from tankers.

New Supply Sources

As is obvious from the discussion of the Cove Point facility, LNG imports are emerging as important new supply source for the nation's energy needs. Currently, three import facilities are receiving ocean-going LNG tankers: the Trachtabel facility in Everett, Massachusetts, the Elba Island, Georgia import facility owned by Southern Natural Gas and a Lake Charles, Louisiana facility owned by CMS Trunkline LNG. In addition to the Cove Point reactivation, the Commission has issued a certificate authorizing Dynegy's plans to construct and operate LNG import facilities at its Hackberry, Louisiana gas processing plant.

In a December, 2001 study, the EIA identified 13 new LNG facilities that have been proposed to serve U.S. markets. The study concludes that, even if only a few of these projects are built, they could still have a very positive effect on U.S. gas markets. The high capital costs associated with LNG import facilities mean that they can be undertaken only by companies that have strong balance sheets. Nevertheless, it appears that a number of companies are going to undertake the construction of LNG import facilities. I look forward to evaluating these projects as they come to us for certificate approval. I expect LNG to increase in importance in meeting our energy needs in the years ahead.

In addition to LNG imports, the Commission has followed with some interest discussions on Capitol Hill concerning ways to bring natural gas from Alaska to markets in the Lower 48 states. Several alternative pipeline routes exits, each one having a unique set of environmental and economic advantages and disadvantages. I have met with a number of potential Alaska gas pipeline sponsors, but thus far, none of the proposed pipeline routes had been filed with the Commission. The only question I have at this juncture is a business question, not a regulatory question: will the current price of natural gas support the construction of such facilities? My own view is that, once the economics justify such an investment, natural gas from Alaska will become an important means of meeting this nation's energy needs. As far as where the pipeline should be built, I have an open mind and will await the filing of certificate applications.

I am generally pleased with the direction of our certificate policy. As the EIA has frequently reported, under virtually all economic scenarios, natural gas use increases dramatically over the next two decades, and substantial pipeline expansion will be required. The Commission is aware of this and is ready to process and evaluate 7c applications in a timely manner. Our processing time has decreased significantly over the past few years. The toughest issue continues to be how to handle landowner concerns. These are especially contentions where facilities must cross heavily populated areas. Obviously, we must balance all concerns. Projects that serve the Northeast have been particularly challenging. Millennium Pipeline, for example, will interconnect with Con Edison at a location within the densely populated City of Mt. Vernon, much to the chagrin of its citizenry. Certificating necessary pipeline facilities remains one of our most challenging jurisdictional arenas. The bottom line is that necessary pipeline infrastructure has to go somewhere, and we have to make some very tough siting decisions to meet our nation's energy needs. Last year, we certificated 11.7 bcf/day in new capacity, and another 7.1 bcf/day is proposed for certification in 2002. These are significant additions to our nation's energy infrastructure.

Although the natural gas marketplace appears to be functioning reasonably well, I do have a concern about the boom or bust cycle we have experienced with natural gas prices. You know the scenario. In 1998, wellhead prices stayed below $2.00 for much of the year, and the rig count dropped dramatically. Demand outpaced supply and prices rose sharply in 2000. The rig count then increased dramatically to well over 1,000 rigs, storage was filled, we have had a warm winter, and prices along with the rig count have again plummeted. Of course, you might simply respond that this is the market at work, and maybe it is. Yet, the price swings seem more volatile than in recent years, and such swings cause political reactions that ultimately are not good for the market.

We face a similar issue with electric markets. Electricity is critical to the social fabric of our nation. We want it to be available and reasonably priced. Some volatility is inevitable, but extreme volatility over a sustained period is not unacceptable. One way to smooth out the volatility is with reserve requirements and capacity obligations. Capacity markets are complex, but we need some feature in our electricity market design to ensure that adequate generating capacity is being built. A capacity short market that leads to extreme price volatility is not in the public interest.

In gas and electricity markets, the peaks and valleys of course can be smoothed somewhat by appropriate hedging strategies, and we at FERC must ensure that pipeline bottlenecks do not keep prices artificially high. Timely certificate decisions are a necessity.

Now let me turn briefly to the issue of the standards of conduct for energy affiliates. Commission policy is to keep the pipeline and its gas marketing affiliate at arms length to guard against self dealing. Under current policy, gas pipelines and their marketing affiliates must maintain functional separation, and any information disclosed to a pipeline's marketing affiliate is disclosed simultaneously on the pipeline's website.

Nevertheless, there is a growing concern that the standards of conduct are insufficient to address the potential for self-dealing. This concern is fueled by the significant changes that have occurred in the energy industry. Mergers and consolidations in the gas and electric sectors have taken place at a brisk pace. Transmission providers often now have a number of gas and electric affiliates. Both physical and financial transactions by pipeline affiliates have burgeoned. The current regulations must be revised to govern the relationship between regulated transmission providers – both gas and electric – and all of their energy affiliates, not just their gas marketing affiliates.

On September 26, we issued a Notice of Proposed Rulemaking to cover all affiliates of the transmission provider. The Commission proposes to broaden the definition of "energy affiliate" to prevent information concerning transmission operations or confidential customer information from being used to benefit any energy affiliate, including affiliates engaged in financial trading of gas and electricity instruments. Pipeline affiliates that engage in electronic trading or energy-related financial transactions would be subject to the separation of function requirement and information sharing prohibitions in the standards of conduct.

Our proposal is highly controversial. Pipelines assert that it is unnecessary and will have some unintended consequences. For example, they believe the proposed rule will limit legitimate dealings between a pipeline and its LDC affiliate. They raise numerous other concerns, as well.

I have an open mind about this proposal. I must believe our affiliate standards must be updated, and so I support the basic thrust of our NOPR. We must ensure, however, that we guard against any unintended consequences that would diminish legitimate operational efficiencies. We have received extensive comment, and now have a full record before us. Surely we can finalize this rule in the spring.

Before I close, let me touch on a couple of other issues. A prominent feature of Order No. 637 was the removal of the price cap on secondary pipeline capacity. This was 2½ year experiment that, by its terms, will sunset in September of this year. Extending the removal of the price cap would require a rulemaking. Our staff is now in the process of evaluating the impact of this experiment on the marketplace and on consumers. I will await their recommendation. I had reservations about removing the cap in the first place, and will have to be persuaded that leaving it off is in the public interest. Does this policy make the market more liquid, or simply impose additional and unnecessary costs on consumers? We will take up this issue in the next few months.

Now, let me comment briefly on OCS issues. For years, the Commission has wrestled with the extent of its authority to regulate on the OCS. A couple of years ago, in a decision involving Sea Robin Pipeline, the Commission yet again attempted to delineate our primary function test as it applies to distinguish gathering from jurisdictional transportation, under the Natural Gas Act. We are now back before the Court of Appeals. The case was recently argued, and we will await the Court's decision.

The Commission's OCSLA jurisdiction has recently been called into question by a federal court. The Commission had adopted a rule that imposed a reporting requirement on OCS pipeline operators. We based the decision on the OCSLA's requirement that OCS pipelines may not discriminate in granting access to their pipelines. We reasoned that it is possible to set transportation rates at such a high level as to preclude access, which would be discriminatory and unlawful. The court did not buy our rationale and struck what could be a mortal blow to any regulatory oversight of OCS activities based on the OCSLA. I think we should appeal.

In conclusion, it is my view that under virtually any economic scenario, the long term future for natural gas appears very bright. The Commission is committed to completing the transition to seamless electric markets based upon the RTO platform, and this should provide significant trading opportunities for gas fired generation. There is a clear focus on infrastructure issues for both gas and electricity markets, and we are committed to issuing certificates in a timely fashion for projects that are in the public interest.

In the nine years I have been at the Commission, our focus has been on making markets work for consumers. We have had some setbacks, and we must heed the lessons that arise from crisis, but our focus remains the same. The main thing is to keep the main thing the main thing. The main thing at the FERC is well functioning energy markets. Thank you.